Get Set For The Relief Rally

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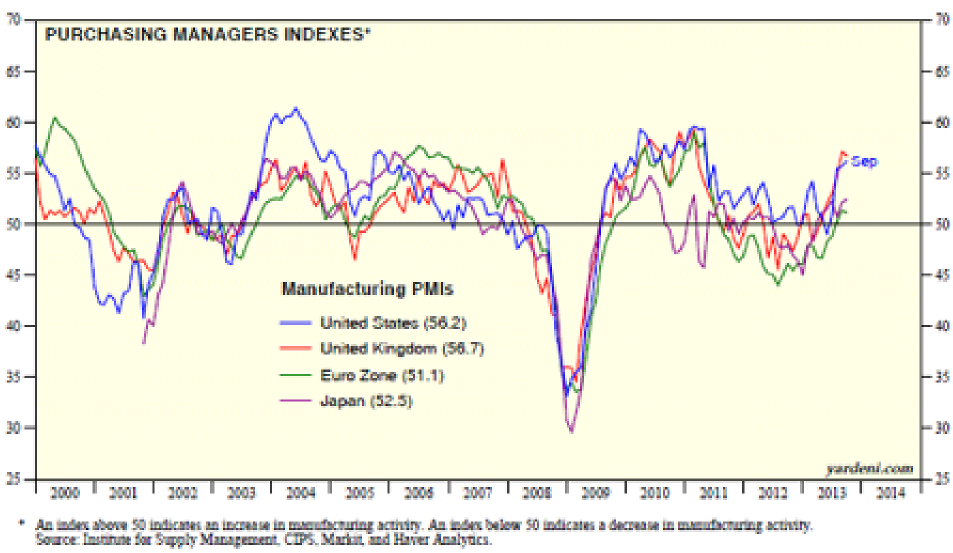
| includes: DIA, QQQ, SPY

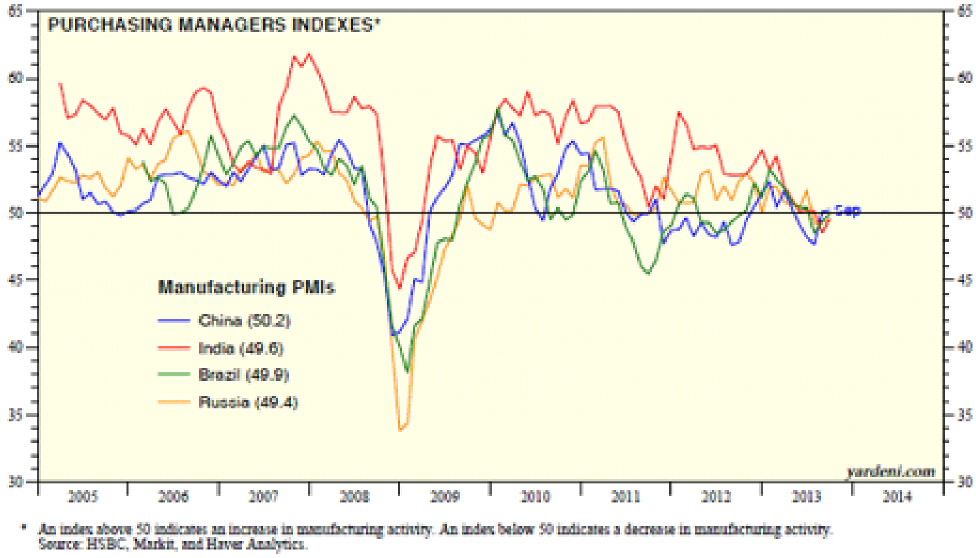
In the past week, the stock market has been acting a little sloppily in the face of the political theatre occurring in Washington. Despite the political risk, I remain bullish short-term. Here is what I see.

The global economy is undergoing a global upturn, as evidenced by Ed Yardeni's depiction of developed market PMIs:



(click to enlarge)

Even the emerging market economies' PMIs, which had been weak, has ticked up recently:



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The stock market recognized the signs of a global upturn for several months. The ratio of the Morgan Stanley Cyclical Index against the market staged an upside relative breakout and remains in a relative uptrend.

(click to enlarge)

Forward earnings estimates for US equities continue to march upward. Brian Gilmartin reports that [emphasis added]:

> Per ThomsonReuters, the "forward 4-quarter" EPS estimate for the SP 500 jumped to $119.04 this week, from last weeks $115.46, which represents a new all-time high for the forward earnings estimate for the key benchmark.

In effect, we are seeing positive fundamentals buoying equities. What are you so worried about?

What political risk?
Oh, yes, there is the minor detail of the political risk posed by the US government shutdown and uncertainty over the debt ceiling. First of all, the economic effects of the government shutdown should be limited, as the House just passed a bill to pay furloughed workers and the military is recalling most of its civilian workforce.

The tail-risk of a US government default should the debt ceiling not get raised is negligible. Speaker John Boehner reportedly told Republicans that he will allow a default to occur. If that's true, then what bargaining leverage does he have left? While I recognize that Boehner went on Sunday talk TV (transcript here) and stated that "we have to make a stand" and that he would not pass a clean debt limit increase, his previous statement to Republicans is a signal that he does not want to go down in history as the Speaker who precipitated a US government default.

Even if negotiations were to go to the brink, Cullen Roche at Pragmatic Capitalism pointed out a piece of analysis by Vincent Reinhart indicating that one of three laws will have to get broken if the debt ceiling isn't raised:

> If the Treasury is unwilling to stretch the definition of extraordinary measures, on the day that the Federal

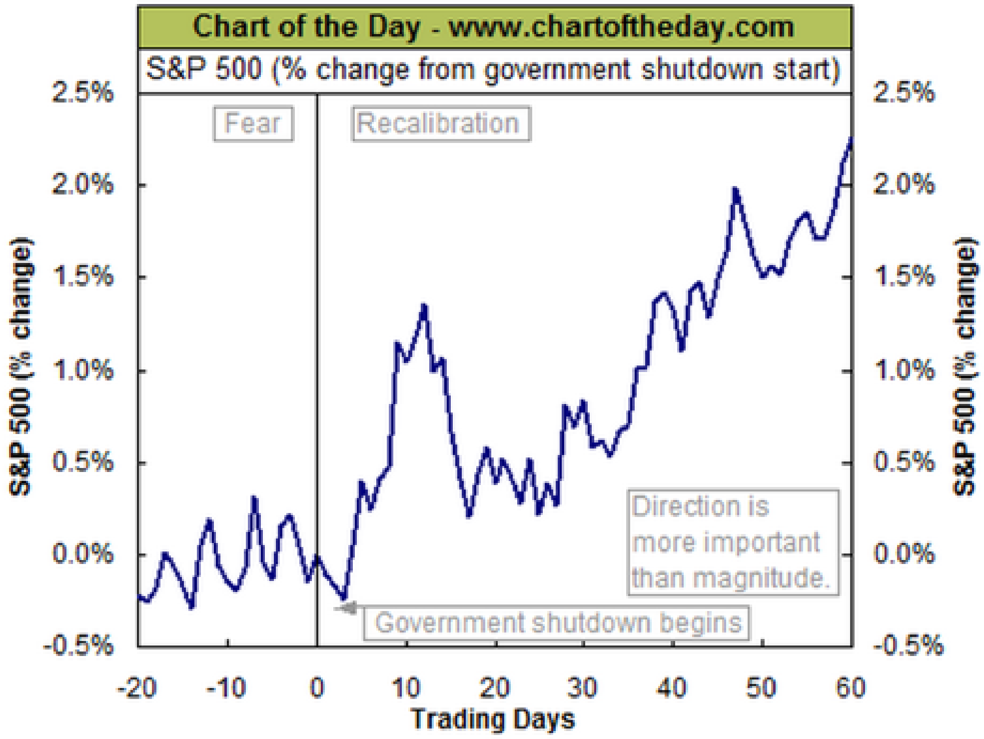
> Reserve predicts that the Treasury will run out of cash in its account and the Treasury is bound by the debt ceiling, it suspends all payments and awaits instructions from the Treasury. As a result, the government's principal economic officials will face the prospect of violating one of these three laws:
>
> 1. The Second Liberty Bond Act of 1917 that establishes the debt ceiling;
>
> 2. The Federal Reserve Act that prohibits the Fed from lending directly to the Treasury; or,
>
> 3. The 14th Amendment of the Constitution that holds that the debt of the United States government, lawfully issued, will not be questioned.

Roche postulated that #3, the Constitution, ranks senior to the other laws, so Treasury Secretary Jack Lew and Fed Chair Ben Bernanke would likely choose to violate #2 in order to prevent a global financial meltdown. However, there would be a conversation that would go something like this before it ever happened:

> Tsy Sec Jack Lew: "Ben, I'm about to break the law here if we don't do something. Oh, and we're about to crash the global financial system. How about you enact the exigent circumstances clause and just fund our account?"
>
> Fed Chief Ben Bernanke: "Sure, but I want some guarantees that I am not going to be the only one on the hook here for this."
>
> Lew: "Sure thing." [Dials in President Obama]
>
> President Obama: "Hey dudes, how can I help?"
>
> Bernanke: "If I am going to save the world AGAIN, I need some guarantees I won't go to jail this time around. Can you guarantee that?"
>
> Obama: "Of course. Your stock market rally saved my skin on more than one occasion. I'll put you at the top of the pardon list."
>
> Bernanke: "Swell. Oh, and I want lifetime beard groomings also. This thing doesn't keep itself looking this good all by itself."
>
> Obama: "Done."
>
> Lew: "Great, now someone phone down to those clowns on the floor of Congress and inform them that their little games are pointless."

(One point that I think everyone can agree about Ben Bernanke - he is a much snappier dresser than Greenspan.) Regardless, the point I am trying to make is there is little or no tail risk.

Various analysts have produced charts showing the past behavior of the stock market before and after past government shutdowns, here is just one example:



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My inner trader is positioned for the relief rally that is likely to occur once the political theatre is out of the way. He may be inclined, however, to sell into the rally depending on how some of the dark clouds on the horizons are developing.

The clouds on the horizon

Despite my short-term bullishness, I do have a number of intermediate and long-term concerns. The more pressing intermediate term concerns are poor market breadth and insider opinion. Many breadth measures for US equities are deteriorating. The chart below shows the SPX in the top panel, which has been advancing steadily, and the number of stocks above the 50 day moving average in the bottom panel, which has shown a pattern of lower highs and lower lows.

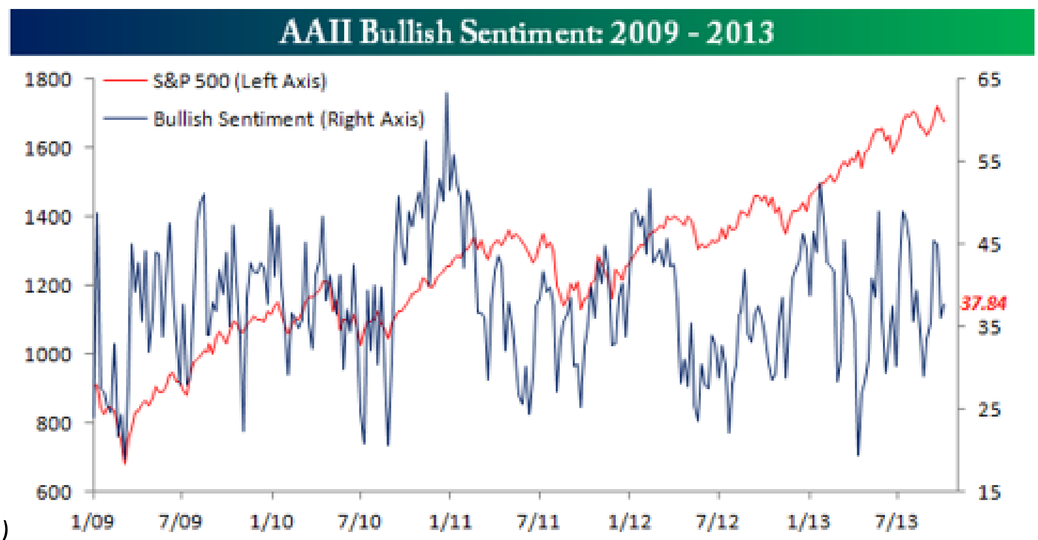
(click to enlarge)

Similarly, the chart below of NYSE New highs - New lows (bottom panel) is also a pattern of deteriorating momentum.

(click to enlarge)

I have watched breadth divergence for decades and I find them useful as only as warning signals. Market breadth can be negative for months before the stock market tops out so they are not useful as day-to-day timing models.

A further intermediate term bearish sign come from sentiment models. Short-term sentiment models of opinions whose readings can be volatile, such as the AAII survey, are still showing low levels of bullishness:



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However, sentiment models with longer time horizons, such as those using Rydex funds, are at cautionary levels. The chart below from Carl Swenlin showing the Rydex bull-bear ratio indicate that bullish sentiment has gotten excessive, but past history has shown that excessive bullish readings do not necessarily lead to immediate declines in the stock market. In addition, Josh Brown has noted a dramatic swing in institutional sentiment from bearishness to bullishness.

(click to enlarge)

Another intermediate term warning sign is insider opinion. Mark Hulbert reports that nearly 50% of CFOs think that the market is overvalued [emphasis added]:

> That surprisingly bearish result is among the findings of the latest Duke CFO Magazine Global Business Outlook survey: 40.2% of chief financial officers who responded to the latest survey said they thought the stock market is overvalued and will correct downward.
>
> Duke finance professor Campbell Harvey, one of the survey's authors, says that he finds this high a percentage to be "striking" because CFOs "usually tell us that their stock is undervalued."

Again, insider models are not useful for pinpointing exact tops and bottoms, but they can be useful for investors with 6-12 month time horizons.

Market valuation warning signals
In addition, I am concerned about the level of stock market valuations. By that, I don't intend to get into a discussion about whether market P/E ratios are stretched or not, but by the behavior of different investors and models with long-term time horizons (see my post A new secular bull? Don't count on it). To summarize the points in that post:

- Private equity funds are selling equities: These guys have made a lot of money over the years. When they seek to sell through the IPO process, who is the smarter investor? Is is the buyer or the seller? As well, see this account from Josh Brown of how tech companies in PE portfolios are suffering from slow or no growth, but sport ambitious valuation multiples.
- Deep value funds are holding cash: They can't find anything to buy. Value investors, in general, tend to be patient traders and they are often early to buy and to sell.
- The Value Line Median Appreciation Potential is flashing a sell signal: VLMAP, as it is called, has a track record going back to 1960 and had has a good track record as a timing model. Unlike the deep value guys, the Value Line model is tilted towards growth factors.

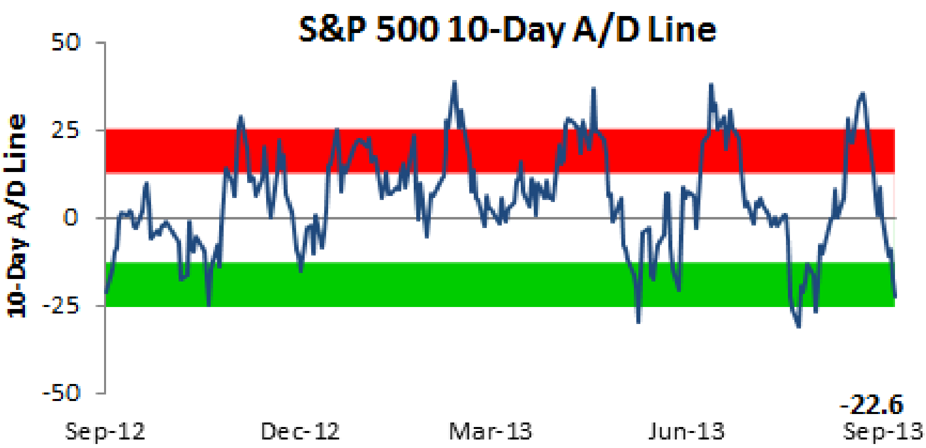
When both Growth and Value are signaling excessive valuation, do long-term investors have to get over the head again to get cautious?

Sell the relief rally?
As I stated before, my inner trader may be getting ready to sell into the likely relief rally. He has his finger on the trigger but he is watching the following:

- How are earnings behaving? Watch the evolution of forward 12 month earnings expectations as we progress through Earnings Season, which starts next week. Byron Wien has gone on record as expecting corporate margins to start contracting in Q3. Thomson-Reuters reported that they are seeing an excessive number of negative corporate guidance, which can be interpreted in one of two ways. Either Earnings Season will massively disappoint (bearish) or the warnings serve to lower the bar for reports and prepare the ground for upside surprises (bullish).

- Are there any signs of global economic weakness? The US consumer is a little wobbly (as per New Deal Democrat). Europe bears watching, as many of the eurozone's problems were swept under the rug in advance of the German election. Now that the election is over, some of them may reappear. As well, China' plenary session of the 18th Party Congress is scheduled in November (see this guide to the plenum from FT Alphaville). What policy shifts are we likely to see and how will affect their growth path?
- What is the likely trajectory of Fed policy? Given the government shutdown and the lack of statistical releases like Employment, a taper at the next FOMC is off the table. In all likelihood, we won't see anything happen until the new Fed Chair takes over next year. Should President Obama announce that he is nominating Janet Yellen for Fed Chair, the markets would likely interpret the development bullishly and such a development should be good for a stock market rally of a few days.

For now, any equity market downside is likely to be limited. Bespoke reports that short-term breadth is in oversold territory and any positive development coming out of Washington will likely cause the market to melt-up.



I would be inclined to enjoy the relief rally once the political crisis is solved. Then watch for the bearish tripwires for signals to take profits.

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